

# PEAT JOHNSON MURRAY

## Chartered Accountants

### TAX AND BUSINESS ISSUES

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#### Company Salaries - Cause for Alarm

Whether a trust or company is required to pay a fair market salary to an associated employee has received considerable attention in recent years. Another case involving the issue was recently heard by the Taxation Review Authority ('TRA'), but the decision included a statement that may start alarm bells ringing.

The case involved a husband and wife who re-structured their activities to operate through a company. The wife was an anaesthetist working part-time in the public sector and also part-time on a private basis through her family trust. The husband operated a quality assurance business. The pair ceased to be self employed in 2002 and were instead employed by the company. The family trust acquired two orchards in 2002 – one from the husband and wife and the other from a third party. The company operated the orchards by leasing both the orchards and equipment from the family trust.

Prior to the restructure, the wife's public sector income as an anaesthetist was approximately \$120,000 per annum. After the re-structure, the company barely made a profit due to losses incurred by the orchard business. Due to the low profit, salaries attributed to the taxpayer were either very low or non-existent during the years in dispute.

The IRD argued that the rent from the leasing of the orchards and equipment that was paid to the family trust was too high, and that the salary paid to the taxpayer was commercially unrealistic, i.e. too low.

In relation to the rent paid to the family trust, the Judge found that though it seemed a little high, the accountant had taken a fairly sensible approach to fixing the orchard rental, and the Judge could not find evidence that there was anything artificial or contrived about the fixing of the rent.

When looking at the salaries paid to the taxpayer however, the Judge found this case to be straightforward. He was of the opinion that the taxpayer had entered into an artificial, contrived and uncommercial arrangement. The Judge agreed with the IRD that the structure was used to significantly reduce the taxpayers income tax liability from personal exertions, while retaining full control and benefiting from the income. This arrangement therefore amounted to tax avoidance.

In the Judge's view, the only reason someone would agree to take such a significant reduction in income was that the income was controlled by a related entity and was still available to them or their family in some other way.

The Judge acknowledged that the same result could have been achieved by paying a fair market salary and electing for the company to be an LAQC or through the use of a partnership. The Judge also commented that a fair market salary could have been payable by the company if it had borrowed against future profits, in effect, causing the company to incur tax losses to be carried forward for future years.

Surprisingly, the High Court decision in the *Penny & Hooper* case was not discussed which found in favour of the taxpayer on the market salary issue. The High Court decision was appealed and the Court of Appeal's decision is currently due to be released. If the Court of Appeal rules in favour of the IRD the TRA decision above is worrying because it is the first time the Authority has taken the view that a company should incur a loss in order to pay a fair market salary and it could be seen as a further movement of the tax avoidance boundary.

## Paying Income Tax from Trading

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It is well known that the IRD have comprehensive powers to request information for the purposes of enforcing the collection of tax. A recent project by the IRD saw those powers directed at identification of on-line traders (using auction websites such as TradeMe) who collectively had not paid over \$1.2 Million of tax over the past three years.

The IRD website advises that as a “general guide”, business income from trading online should be declared (and taxed) if:

- the goods were acquired for the purpose of on-selling,
- the purpose of the activity is to make a profit, or
- the business involves dealing in these goods.

It is important to note that, despite the fact that the IRD’s message is specifically in the context of on-line trading, the same principles can be applied to all types of trading activities.

Irrespective of what a person is doing, whether it is on-line or otherwise, the IRD is likely to apply one of two criteria, namely:

- have goods been purchased with a purpose of resale, or
- does the level of activity indicate that a business exists.

If either criterion applies all profits from the trading are taxable.

In order to determine “purpose”, the IRD is likely to rely on documentary evidence. Without evidence it becomes an argument over a person’s intention, which is difficult to establish at the best of times. If a person does not have a purpose of resale the IRD could instead argue that a business exists, which case law has shown can be proven on the facts of a particular case. As stated in the Court of Appeal decision of *Grieve v Commissioner of Inland Revenue* in 1984, “whether a business existed turned on the intention of the taxpayer as evidenced by his conduct”.

In the *Grieve* case the taxpayers had to prove that their farming activities were a business in the 1976 and 1977 income years, even though it had been operating at a loss. The result was a thorough analysis of what, in the context of the Income Tax Act, is meant by the term “business”. The tests arrived at by the Court are:

- statements by the taxpayer as to intention
- the nature of the activity
- the period over which the activity is engaged
- the scale of operations and the volume of transactions
- the commitment of time, money and effort
- the pattern of activity
- the financial results
- whether the activity is run in the same way as other businesses in that particular trade

It is better to consider the tests above, reach your own conclusion and gather evidence that a business exists, before the IRD come knocking on your door.

## GST Increase – Be Prepared

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As a business owner/operator it is worth taking the time to consider what effect the GST increase will have and what planning can be done to minimise any disruption.

The change in the GST rate should be considered from various angles. There is the mechanical aspect, i.e. the methodology of preparing and filing a GST return through the “change” period. Also, the behavioural aspect, such as, will the rate increase affect patterns of supplier and customer behaviour? Finally, there are other points, including cash flow issues that will be helpful to keep in mind. The following looks into these various aspects.

If a GST rate increase comes into effect part way through a business’s GST period, two GST returns have to be completed. For example, with the rate increase expected to be effective from 1 October 2010, a GST return that ordinarily covers the two month period ending 31 October 2010, will need one GST return for the month to 30 September and another for the month to 31 October.

The process of transitioning to the new rate varies depending on whether a person is on the payments or invoice basis.

Payments basis - debtors and creditors existing at the time of the change are subject to a notional 2.5% conversion and then all payments or receipts are subject to 15%. The notional conversion has the effect of deeming payments or receipts relating to transactions prior to the rate increase to be at a net 12.5%.

Invoice basis – the transition process for those working on an invoice basis may be more complicated. Most accounting packages are set up with a default GST rate of 12.5%. However, in various circumstances an accounting package will need to simultaneously cater for GST at 15% and 12.5%. For example:

Purchases subject to GST at 12.5% may be claimed after the rate increase, along with other purchases that are subject to GST at 15%, or

Credit and debit notes need to be issued or are received at the old rate because of when the original supply took place.

As this transition process is potentially complex, it is advisable to seek guidance from an accountant so that it is navigated correctly.

Systems set up to automatically code repeat transactions will need to be reviewed or switched to manual coding during the transitional period. If an accountant is completing the GST return(s), the client will need to specify which rate applies to every transaction, especially in the periods immediately after the change.

It is likely that businesses will experience an increase in sales to consumers prior to the increase coming into effect. This increase in activity could be in the form of purchases, purchase arrangements where the old rate is “locked-in” or the pre-payment of recurring expenses. Where possible steps should be taken to meet, or take advantage of this demand.

Other points to keep in mind include:

Reviewing contracts with suppliers and customers to confirm that the effects of the rate change will be neutral. Generally, the GST Act deems a contract to be altered to align with a GST rate change, unless the contract specifies otherwise, or the contract is entered into more than three months after the rate increase.

Increasing the amount of a deposit when selling large value assets to avoid having to fund the GST output liability to the IRD prior to full payment being received.

The increase from 12.5% to 15% represents a 20% impact on cash flow when waiting for a GST refund to be released by the IRD.

The change to the GST rate will take place on the 1<sup>st</sup> October, 2010, planning should be undertaken now to determine if your business and your GST return process are properly geared up for the transition and new GST rate. It may be helpful to consult an accountant to enable a smooth transition.

## Cash Flow Forecasts and Budgets

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It is often said that “failing to plan is like planning to fail”. In today’s economic climate the need to plan is critical to the ongoing success, and in some instances survival, of your business. Two effective tools for planning are budgets and cash flow forecasts.

A budget encourages you to look forward and forecast what your income and expenses will be for the upcoming year. Once the budget is set, regular comparisons against actual performance will enable you to investigate any variances and take action where necessary. This pro-active approach will help you to make informed decisions.

The budget can be used to help you start planning for your cash commitments. However profitable your business may appear to be, cash is still the lifeblood of any organisation. Common questions asked by business owners are, “if the or purchasing tax from a tax intermediary. The cash flow forecast can also indicate whether you may need to review your current banking arrangements. Perhaps you may need to re-negotiate payment terms with your suppliers or introduce measures to encourage debtors to part with their cash earlier, such as early payment discounts or penalty interest for late payments.

Regularly reviewing your liquidity and where your business is at financially will also mean that when the bank manager requests this information you have it on hand. As banks are becoming more cautious with their lending, there has been an increase in the request for up-to-date financial

business made a profit for the year why does the bank balance not reflect this?” and “where has the money gone?” Unfortunately sales do not always equal cash and this can make it difficult when it comes time to pay the bills. Collection of cash from customers can at times prove challenging. Likewise, business owners need to be able to live, and often drawings are overlooked when it comes to cash management.

A cash flow forecast enables you to anticipate any shortfalls that may occur and to make plans accordingly. For example, if it looks like cash is going to be tight when a taxation payment is due, there are various options available to you to minimise underpayment penalties and interest – whether it be organising a payment plan with Inland Revenue

information. If you are able to produce budgets and cash flow forecasts for your bank manager in a timely manner it demonstrates you have a good grasp on the financial state of your business. Of course the quality of this financial information is crucial. It would be a wise move to engage an accountant to assist you with this process.

There are numerous tools that can be used to prepare budgets and cash flow forecasts, whether they are part of your current accounting system, an excel spreadsheet or a more sophisticated specialist piece of software. What is important is that they do become an integral part of your business planning.

## Snippets

### IRD Recording Interviews

The IRD is increasingly conducting interviews using audio recording technology, and has recently sought feedback on its Standard Practice Statement (SPS) for recording interviews with taxpayers.

It is important to note that most interviews are voluntary. The only exception is a compulsory interview under section 19 of the Tax Administration Act (provision for the IRD to require a person to give evidence). These are always electronically recorded, using video recording technology in appropriate cases, and the interviewee's consent is not required. However, attendance by the taxpayer at initial investigation meetings and follow up meetings is generally voluntary in nature.

Excluding section 19 interviews, a taxpayer will be asked before the interview if they consent to the interview being recorded. The taxpayer has the right under the Privacy Act 1993 to not consent to the interview being recorded. The reasons behind the refusal are not important and the

taxpayer is not required to justify their decision to refuse. The draft SPS advises that the IRD will respect the taxpayer's decisions.

### KiwiSaver and Business Transfers

On the sale of a business from one company to another, or when companies amalgamate, existing employees are often employed by either the purchasing or amalgamated company. Typically, automatic enrolment into KiwiSaver occurs on commencement of new employment. However, this type of situation is excluded from being treated as "new employment" for KiwiSaver purposes.

Specifically, "new employment" does not include situations where the employee remains on the same payroll or where an employer carries on the "same business", as long as the employee was previously employed on that payroll or in that business. The "same business" is defined as a business that in substance carries on the same or a similar role and includes an amalgamated company or a business taken over as a going concern.

## STAFF NEWS

Georgie Webber recently achieved a tremendous personal goal by competing in her first marathon. We are all really proud of her achievement. We hope she will recover soon and be back at work. We definitely notice her absence, both in work and laughter.



***If you have any questions about the newsletter items, please do not hesitate to contact us.***

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